The Toy Association White Paper

Looking Beyond Credit Insurance: Why Factoring May Be the Best Solution in an Uncertain Retail Climate

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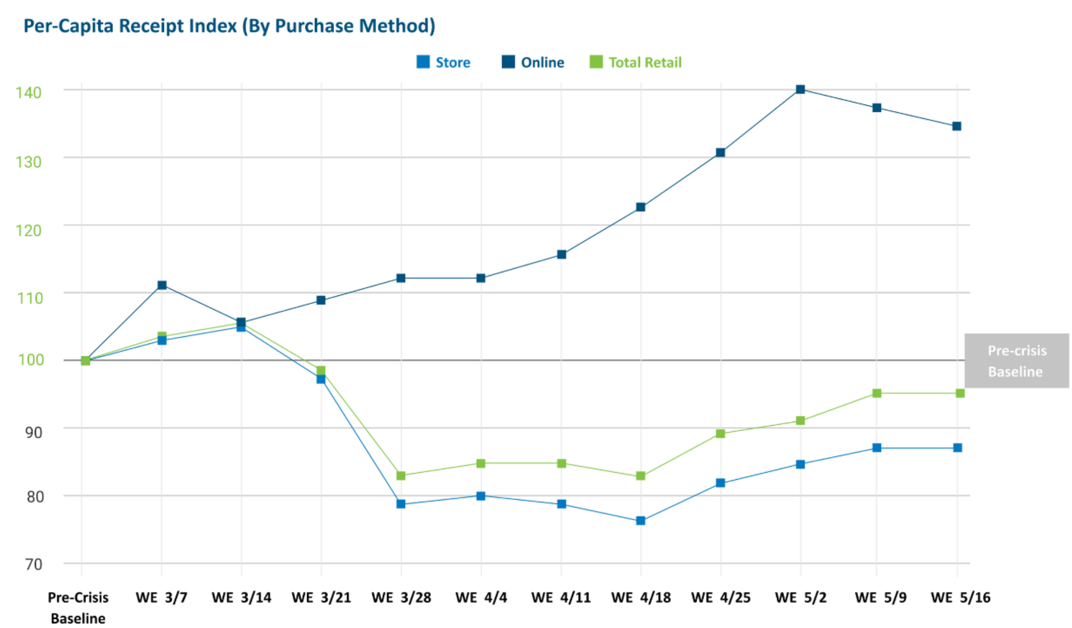
LOOKING BEYOND CREDIT INSURANCE:
WHY FACTORING MAY BE THE BEST SOLUTION IN AN UNCERTAIN RETAIL CLIMATE

By Joel Wolitzer, Rosenthal & Rosenthal

The economic impact of COVID-19 is being felt across every industry, region and company right now. The pandemic has touched nearly every business in significant ways, no matter their size or specialty. And with no clear end in sight, companies have had to adjust to a new way of doing business. Some sectors have been harder hit than others. Retail has been dealt one of the hardest blows, with sales falling 16.4% in April alone – the largest monthly drop on record. Total retail purchases (both in store and online) were the lowest since 2012.

THE SHIFTING RETAIL PARADIGM

Retail is experiencing one of the most rapid transformations of any sector right now. We're seeing the effects of that transformation in store closures, bankruptcies to lay off debt and companies rushing to beef up their e-commerce channels as brick-and-mortar sales continue to shrink. Furloughs, workforce reductions, terminated sales contracts and shuttered retail locations have become the new norm.



Source: The NPD Group/Checkout, WE May 23, 2020

Even with retail sales down across the board in April, the sector has seen a boom in online shopping with e-commerce sales jumping to 49%. Stay-at-home orders contributed significantly to that spike and online growth was primarily fueled by essentials like groceries, household items, electronics, books and, yes, toys. Shifting consumer behavior has also been a contributing factor as more and more customers are opting to shop online. Only a few sectors have experienced growth during this tumultuous period, and the toy industry has been one of the lucky few.

THE STATE OF THE TOY INDUSTRY

As The NPD Group recently described it, "while COVID-19 has wreaked havoc on the global economy, it has bolstered the toy industry in the U.S." In mid-March – in the early days of widespread lockdowns and sheltering in place – toy sales were up 26%. In fact, at a time when nearly every other sector has been hamstrung by an immediate halt in sales and months of backlogged inventory, the toy industry has seen a spike in sales since the beginning of the pandemic. In April alone, the total U.S. toy industry grew 22%.

The numbers have been staggering – a 228% increase in games and puzzles, a 76% spike in building sets, a 70% boom in arts and crafts, all during a single week in March (The NPD Group). Overall in Q1 2020, the industry saw a 7.6% increase in sales over the same period last year, driven primarily by widespread stay-at-home orders and school closings. As a result, with more families home with more time on their hands, all major categories across the industry saw spikes in sales.

Q1 2020 Toy Category Growth

Games & Puzzles	55%
Outdoor & Sports	22%
Building Sets	20%
Arts & Crafts	13%

Source: The NPD Group

Looking ahead, if stay-at-home orders continue or are reinstated in some states, this uptick in sales across the toy sector is sure to continue. We will also likely see seasonal spikes in specific toy categories over the next 12-18 months, similar to what we are now seeing in the Outdoor & Sports category with summer on the horizon.

FACTORING VS. CREDIT INSURANCE: WHAT YOU NEED TO KNOW

A toy company trying to plan ahead amid all this uncertainty cannot afford to get caught with excess inventory or be exposed to bad debt from a retailer. In the world we're operating in now, one bad season or an order with a retailer with bad credit could make or break a business.

In a good credit environment, credit insurance is often the go-to for many toy companies that are less familiar with the advantages of working with a factor, primarily because insurance is a lower-cost option. But in a difficult credit environment like the one we're in – and are projected to be in for some time – factoring can be an even more powerful tool in a company's strategy for moving forward.

Factors provide larger credit lines and often approve more customers, while credit insurers may reduce their credit lines or pull them altogether. Factors are able to approve more credit than credit insurers, mainly because factors have deeper and more established relationships with the majority of retailers. This also allows for a steadier, more consistent and robust flow of financial information. In fact, factors are sometimes privy to confidential information about retailers that credit insurers and others in the trade don't receive. Additionally, factors can provide working capital when a company needs it most and can help businesses streamline operations and reduce overhead for collections and receivables management.

Although credit insurance is less expensive, toy companies must look at what benefits insurers actually provide. In most cases, the lower cost of insurance is reflective of the coverage they offer. By contrast, partnering with an experienced factor not only gives a company a means to protect its accounts receivable – generally a company's largest asset – but it also allows the company to outsource some of its more tedious and time-consuming back office functions.

THE PITFALLS OF CREDIT INSURANCE

In a typical non-pandemic environment, credit insurance is often a good choice for a toy company selling to several smaller mom and pop retailers. In that scenario, the exposures are typically very small and insurance companies can usually provide blanket credit lines to cover the exposures for a reasonable fee.

But that is not the world toy companies are operating in today. Now, those same mom and pop stores have been some of the hardest hit by the economic impacts of the pandemic. As a result, vendors are relying on more sizeable shipments to larger retailers or specialty stores that offer more scalability. The credit assurances from a traditional credit insurance company may not be sufficient to protect the business from the increased exposure they're facing.

Overall, credit insurance is an affordable solution, though it provides significantly less coverage. It's important to note that credit insurance does not cover 100% of bad debt. Typically, a credit insurance company provides lower credit lines, only 90% coverage, along with some form of deductible, and in many cases may not even be insuring certain customers. That might work fine under normal circumstances, but in this shaky retail environment, that is a risky proposition.

BENEFITS	FACTORING	INSURANCE
Protection from high-risk customers	✓	X
No deductible, 100% coverage	✓	X
Real-time customer reviews/updates	✓	
Full-service collections department	✓	
Dedicated full-service team	✓	
Access to decisionmakers	✓	
Advances against receivables, if desired	✓	

THE BENEFITS OF FACTORING

Factoring is a valuable tool for any company operating in this complex environment and selling into retail channels. An experienced factor can help toy companies avoid bad debt when selling to big box retailers, specialty stores, or regional retailers where they are unsure of their creditworthiness. Generally speaking, toy companies, or any importer or manufacturer for that matter, do not focus their time on evaluating the financial condition of their customers. Companies should be selective about which partners they opt to work with and only team up with a factor who truly knows the retailers well.

Outsourcing back office accounts receivable collection functions is a great benefit to a company that may have reduced their workforce as a result of the pandemic or is cash-constrained in other ways. Although many companies may be reluctant to turn over their collection process to a factor, more often than not, an effective factor is able to collect quicker than the importers simply because of economies of scale. When a factor calls up a retailer for payment, they are calling on behalf of many clients. This kind of leverage is valuable and crucial at a time when retailers are demanding longer payment terms and stretching their payables where they can.

An additional benefit of factoring, beyond credit protection, is that factors can generally provide working capital financing against a company's credit-approved receivables. Even when retailers extend terms or delay payments, a company would still have access to draw advances against credit-approved receivables. These working capital lines of credit generally work similarly to a traditional bank financing model, but with significantly more flexibility. Factors also can lend against inventory, and in some cases, provide financing against purchase orders.

GETTING BACK ON TRACK

In the current climate around COVID-19, even the healthiest business have the potential to hit a wall when credit tightens and liquidity becomes less readily available. When that happens, things begin to unravel quickly. The collateral coverage under the credit facility tightens, which leads to insufficient funding. Trade terms with suppliers are jeopardized, reduced or terminated altogether. But, demand for the company's product may still be high, which is especially true in the case of toy companies.

With so much interest in toys right now, forecasting future demand has never been more important. It has also never been more difficult. Managing and maintaining an appropriate mix of inventory is key. As they're thinking about inventory, companies will need to also keep a close eye on cash flow management and have the right cost controls in place.

Diversification will be especially important for companies as they develop plans to serve their customers in different parts of the country – and different countries around the world – all of which are affected differently by COVID-19. When regions reopen and inevitably tighten up again, companies will need to plan accordingly to ensure they can get their products to the places where they can most easily be sold.

Central to all of this is how companies can effectively assess the creditworthiness of retailers amid COVID-19 impacts. This will no doubt be one of the most significant hurdles for toy companies to overcome in the next 12-18 months. Any company lacking solid credit protection coverage heading into the remainder of 2020 and looking ahead to 2021 should be focused on this – and concerned.

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Reading the tea leaves, it's becoming clearer that companies must make difficult decisions and adapt if they are to survive. The toy companies that will continue to thrive in this climate will be the ones that remain flexible, embrace creativity, stay on top of trends and take steps to understand their customers' needs. Finding the right partner you can trust, that has experience helping companies navigate and grow amid challenges and crises, can make all the difference.

For more information about factoring with Rosenthal & Rosenthal, please visit www.rosenthalinc.com and contact Joel Wolitzer at JWolitzer@rosenthalinc.com or 212-356-0939.